COMPLEX CASE

ORAL ARGUMENT SCHEDULED FOR OCTOBER 17, 2001

No. 00-1174 and Consolidated With 00-1175
00-1176, 00-1177, 00-1178, 00-1179, 00-1180,
00-1181, 00-1182, 00-1184, 00-1185

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON,

PETITIONER,

v.

FEDERAL ENERGY REGULATORY COMMISSION

RESPONDENT.

ON PETITION FOR REVIEW OF ORDERS OF THE FEDERAL ENERGY REGULATORY COMMISSION

JOINT BRIEF OF JURISDICTIONAL UTILITIES AND SUPPORTING INTERVENORS

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CERTIFICATE AS TO PARTIES, RULINGS AND RELATED CASES

Pursuant to Circuit Rule 28(a)(1), the undersigned counsel of record certifies as follows:

A. Parties, Intervenors, and Amici

The following is a list of all parties,[1] intervenors, and amici in this case and the case below:

Alabama Electric Cooperative, Inc.
Alliant Energy Corporation
Ameren Services Company
American Electric Power Service Corporation
American Electric Power System
American Iron & Steel Institute
American Public Power Association
Arkansas Electric Cooperative Corporation
Baltimore Gas and Electric Company
Boston Edison Company
California Electricity Oversight Board
Cambridge Electric Light Company
Central Hudson Electric & Gas Corporation
Central Illinois Light Company
Central Illinois Public Service Company d/b/a Ameren (on behalf of Central Illinois Public Service Company d/b/a Ameren CIPS and Union Electric d/b/a Ameren UE)
Chemical Manufactures Association

[1] This list includes all parties who filed petitions for review before the agency. Commentators on the proposed regulations are not listed below but are included as an appendix to Order No. 2000. Order No. 2000 is reproduced in the Joint Deferred Appendix.

Cinergy Corp. (on behalf of Cincinnati Gas & Electric Company,
PSI Energy, Inc., and Union Light, Heat & Power)
Cities of Anaheim, Azusa, Banning, Colton, and Riverside, California
Coalition for a Competitive Electricity Market
Commonwealth Edison Company
Commonwealth Edison Company of Indiana
Commonwealth Electric Company
Competitive Transmission Association, Inc.
Conectiv
Consolidated Edison Company of New York, Inc.
Consumers Energy Company
Consumer Federation of America
Council of the City of New Orleans, Lousiana
Dairyland Power Cooperative
Detroit Edison Company
Duke Energy Corporation
Dynegy Inc.
East Texas Electric Cooperative, Inc.
Edison Electric Institute
Electricity Consumers Resource Council
Entergy Arkansas, Inc.
Entergy Corporation
Entergy Gulf States Inc.
Entergy Louisiana, Inc.
Entergy Mississippi, Inc.
Entergy New Orleans, Inc.
Entergy Services, Inc.
Electric Power Supply Association
Federal Energy Regulatory Commission (FERC)
FirstEnergy Corp.
Georgia Power Company
Golden Spread Electric Cooperative
GulfPower Company
Hoosier Energy Rural Electric Cooperative, Inc.
Illinois Power Company
Kansas Electric Power Cooperative, Inc.
Kentucky Utilities Company
Jersey Central Power and Light Company
Long Island Power Authority
Louisville Gas & Electric Company

Maine Public Utilities Commission
Metropolitan Edison Company
Metropolitan Water District of Southern California
Michigan Public Service Company
Mississippi Power Company
Montaup Electric Company
National Association of State Utility Consumer Advocates
National Grid Group
National Rural Electric Cooperative Association
New England Conference of Public Utilities Commissioners
New England Power Company
New York State Electric & Gas Corporation
Niagara Mohawk Power Corporation
North Carolina Electric Membership Corporation
Northeast Texas Electric Cooperative, Inc.
Northeast Utilities Service Company
Northern States Power Company (Minnesota)
Northern States Power Company (Wisconsin)
NSTAR Services Company
Old Dominion Electric Cooperative
Oneok Power Marketing Company, Inc.
Orange and Rockland Utilities, Inc.
Pacific Power & Light (PP&L), Inc.
PECO Energy Company
Pennsylvania Electric Company
Pennsylvania Power & Light
Pennsylvania Public Utility Commission
PJM Interconnection, L.L.C.
Potomac Electric Power Company
Power Authority of the State of New York
PP&L EnergyPlus Co., LLC
PP&L Montana, LLC
Public Service Electric and Gas Company
Public Utility District No. 1 of Snohomish County, WA
Puget Sound Energy, Inc.
Rochester Gas and Electric Corporation
Sacramento Municipal Utility District
Salt River Project Agricultural Improvement and Power District
Sam Rayburn G&T Electric Cooperative, Inc.
Savannah Electric and Power Company

Seminole Electric Cooperative, Inc.
South Carolina Public Service Authority
Southern California Edison Company
Southern Company Services, Inc.
(acting as agent for Alabama Power Company)
Southern Illinois Power Cooperative, Inc.
Southern Indiana Gas & Electric Company
South Mississippi Electric Power Association
State of Michigan
Steel Dynamics, Inc.
Tex-La Electric Cooperative of Texas, Inc.
Trans-Elect, Inc.
Transmission Access Policy Study Group
Transmission Agency of Northern California/Modesto Irrigation District
Transmission Dependent Utility Systems
United Illuminating Company
Utilities Commission, City of New Symrna Beach, Florida
Vermont Department of Public Service
Vermont Electric Power Company
Virginia Electric and Power Company
Wabash Valley Power Association, Inc.
Wisconsin Electric Power Company

B. Rulings Under Review

Petitioners seek review of the following two orders of the Federal Energy Regulatory Commission:

- *Regional Transmission Organizations*, Final Rule, 89 FERC ¶ 61,285 (1999), III FERC Stats. & Regs. (CCH) ¶ 31,089 ("Order No. 2000") (1999), *reprinted at* 65 Fed. Reg. 810 (January 6, 2000); and
- *Regional Transmission Organizations*, Order on Rehearing, 90 FERC ¶ 61,201, ("Order No. 2000-A"), III FERC Stats. & Regs. (CCH) ¶ 31,092, *reprinted at* 65 Fed. Reg. 12088 (March 8, 2000).

Both orders are reproduced in the Deferred Joint Appendix.

C. Related Cases

The case on review has not previously been in this Court or any other court.

The undersigned counsel is aware of the following related cases currently pending before this Court:

- *Baltimore Gas and Electric Company, et al., v. FERC*, No. 00-1460;
- *Public Service Electric and Gas Company v. FERC*, No. 00-1459; and
- *Public Service Electric and Gas Company v. FERC*, No. 00-1503.

The above information is certified to be correct to the best of my knowledge, information, and belief.

Charles G. Cole

Charles G. Cole

Dated: February 21, 2001

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FEDERAL STATUTES

ADMINISTRATIVE REGULATIONS

ADMINISTRATIVE CASES

MISCELLANEOUS

GLOSSARY

ALJ	Administrative Law Judge
Commission	Federal Energy Regulatory Commission
EEI	Edison Electric Institute
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
FPC	Federal Power Commission (FERC's predecessor agency)
ISO	Independent System Operator
NGA	Natural Gas Act
NOPR	Notice of Proposed Rulemaking
OASIS	Open Access Same-Time Information System
OATT	Open Assess Transmission Tariff
PBR	Performance Based Rates
PJM	Pennsylvania-New Jersey-Maryland Interconnection
RTO	Regional Transmission Organization

JURISDICTION

This Court has jurisdiction to review the challenged rulings by the Federal Energy Regulatory Commission ("FERC" or "Commission") pursuant to the Federal Power Act ("FPA") § 313(b), 16 U.S.C. § 825*l*(b) (1994). FERC denied rehearing on February 25, 2000, which constituted a final order. The petitions for review were filed on April 24, 2000.

STATEMENT OF ISSUES

1. Whether FERC exceeded its statutory authority when it directed that regional transmission organizations ("RTOs") must have independent and exclusive authority to make and file rates for services provided over transmission facilities owned by their member utilities and thereby deprived those member utilities of their filing rights under FPA section 205?

2. Whether FERC failed to engage in reasoned decisionmaking when it assigned control over customer transmission rates to an entity independent from the owner of the transmission assets and thereby subjected the owner to an unreasonable risk of an inadequate recovery of its costs?

3. Whether FERC arbitrarily concluded that a fundamental change in the ratemaking process was needed to address operational problems in the management of the transmission grid?

4. Whether FERC acted unlawfully or arbitrarily in categorically prohibiting the parties from exercising their statutory right to enter into contractual arrangements, in establishing RTOs, that determine the ability of RTOs to unilaterally seek future changes to the FERC-approved RTO tariff under section 205?

5. Whether in promulgating a final rule concerning the establishment of RTOs, FERC acted unlawfully and arbitrarily by failing to modify its open architecture regulations to be consistent with its findings in Order No. 2000-A?

6. Whether in promulgating a final rule concerning the establishment of RTOs, FERC acted unlawfully and arbitrarily by refusing to require that any RTO-mandate of interconnections to or expansions of any transmission owners' facilities adhere to the requirements of sections 210, 211, and 212, thereby abrogating the statutory and constitutional rights of the owners of the transmission facilities?

STATEMENT OF THE CASE

Petitioners are the Edison Electric Institute (an association of United States investor-owned electric utilities and industry affiliates) and a number of public utilities that have formed three independent system operators ("ISOs"): (1) PJM

ISO[1]; (2) ISO New England[2]; and (3) NY ISO.[3] They are supported by Intervenors, who are transmission-owning members of the Midwest ISO.[4] At the invitation of FERC, Petitioners and Intervenors agreed by contract to give these ISOs functional control over the operations of their transmission systems. While each ISO is structured differently, the member utilities executed agreements that preserved for them some degree of control over the rates charged to customers for transmission service using their transmission facilities.

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[1] Baltimore Gas and Electric Company, Conectiv, Potomac Electric Power Company, PPL Electric Utilities Corporation, and Public Service Electric & Gas Company.

[2] Northeast Utilities.

[3] Central Hudson Electric & Gas Corporation, Consolidated Edison Company of New York, Inc., New York State Electric & Gas Corporation, Niagara Mohawk Power Corporation, Orange and Rockland Utilities, Inc., and Rochester Gas and Electric Corporation (collectively, "NY Transmission Owners").

[4] Ameren (on behalf of Central Illinois Public Service Company d/b/a Ameren CIPS and Union Electric d/b/a Ameren UE), Central Illinois Light Company, Cinergy Corp. (on behalf of Cincinnati Gas & Electric Company, PSI Energy, Inc., and Union Light, Heat & Power), Commonwealth Edison Company and Commonwealth Edison Company of Indiana, Hoosier Energy Rural Electric Cooperative, Inc., Kentucky Utilities Company, Louisville Gas & Electric Company, Northern States Power Company and Northern States Power Company (Wisconsin), Southern Indiana Gas & Electric Company, Southern Illinois Power Cooperative, Wabash Valley Power Association, Inc., and Wisconsin Electric Power Company (collectively, "Midwest ISO Participants").

In Order No. 2000,[5] FERC established minimum requirements for RTOs. Like the ISOs, RTOs will be independent operators of transmission facilities. They may be either "transcos" that acquire the transmission facilities they operate, ISOs that control the operation of transmission facilities of the participating utilities, or combinations of the two. Through a series of specific restrictions regarding ownership and management affiliations, FERC assured that RTOs would be independent of all market participants, including the utilities that transferred ownership or operating control of their transmission facilities. FERC contemplates that all public utilities will join an RTO in their geographic region, and transfer control over their transmission assets – by operating agreement or outright sale – to the RTO. These aspects of the Final Rule are not contested here.

FERC then further mandated that the RTOs must have exclusive authority under section 205 to make and file rates for service to consumers using the transmission facilities of their participating utilities. In the case of ISOs, the participating utilities would be allowed to file only an overall "revenue

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[5] *Regional Transmission Organizations*, III FERC Stats. & Regs. Preambles (CCH) ¶ 31,089 ("Order No. 2000") (1999) (Joint Appendix ("JA") 399-652A).

requirement"[6] for their transmission facilities. FERC refused to recognize the statutory right of transmission owners to impose reasonable limitations on an ISO's ability to modify the agreements pursuant to which the ISO acquires control over the transmission assets. FERC also failed to modify its Final Rule to clarify that RTO-related transmission expansions must comply with the limitations and conditions that Congress imposed on FERC through sections 210-212. These aspects of the rule are the subjects of this appeal.

FERC's new rule would deprive those Petitioners participating in the ISO form of RTO of their rights under section 205 to design and file changes to the FERC-approved RTO tariff applicable to the use of their transmission facilities.[7] Petitioners explained to FERC on rehearing that the separation of the design of

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[6] A utility's "revenue requirement" is the aggregate of its costs incurred annually to provide a regulated service, such as transmission service. The revenue requirement consists of a return on the utility's investment in property used to provide the service plus its operating costs and taxes. In the ratemaking process, the utility's revenue requirement is the starting point for the design of rates; it has never before been viewed as an end in itself. Under longstanding ratemaking practice, the revenue requirement is merely an element in the formula used to determine the rates charged to customers.

[7] These issues do not apply to an RTO that owns all of the transmission facilities under its control.

rates from the determination of the revenue requirement is unprecedented and unworkable; that the denial of section 205 authority jeopardized their ability to recover their costs; and that the problems identified in Order No. 2000 were adequately addressed by giving operational control to the RTO, without effecting a radical change in the process by which transmission service rates are established under the FPA. NY Transmission Owners also advised FERC that it could not and should not ban reasonable limitations on an RTO's authority to modify the enabling agreements pursuant to which the transmission owners granted control over their assets worth billions of dollars to the RTO. Finally, NY Transmission Owners explained that FERC did not have the authority to waive the requirements of sections 210-212 by transferring the authority to require transmission expansions to RTOs. On February 25, 2000, FERC denied rehearing in Order No. 2000-A.[8]

Petitioners do not challenge in this appeal FERC's overarching RTO objectives. Petitioners seek review in this Court only to preserve the fundamental statutory right to make and file FERC-approved RTO rates; reasonable limits on

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[8] *Regional Transmission Organizations*, III FERC Stats. & Regs.- Preambles (CCH) ¶ 31,092 ("Order No. 2000-A") (2000) (JA 772-814).

the RTO's authority over transmission owners' assets; and certain statutory protections that are prerequisites to any FERC order requiring transmission expansions. FERC's decisions contemplate that public utilities must place billions of dollars of transmission assets under the partial control of RTOs that do not have an ownership interest in those assets, without any reasonable assurances that (1) FERC-mandated transmission services using those assets will be priced at levels sufficient to compensate their owners; (2) the RTO will not change its degree of control over the assets without the owners' consent; or (3) the ordered changes satisfy statutory requirements.

STATEMENT OF FACTS

Background. Historically, electric utilities were vertically integrated entities that owned generation, transmission, and distribution facilities. Each system covered a limited geographical service area and provided a "bundled service" (delivered electric energy) to wholesale and retail customers. Beginning in the 1960s, technological advances made transmission of electric power over long distances at higher voltages more economical. Changes in the law and in technology also enabled new power suppliers to construct generation facilities and produce electrical energy at competitive prices. Their needs for transmission service raised questions of fair access to the grid. *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000).

In Order No. 888,[9] FERC implemented open access to the transmission grid. Order No. 888 required all public utilities that owned, controlled, or operated jurisdictional transmission facilities to file non-discriminatory open access transmission tariffs ("OATT"). These were to contain certain minimum non-price terms and conditions mandated by FERC in its pro-forma tariff. In addition, FERC required public utilities to unbundle their wholesale transmission function by stating separate rates for wholesale generation, transmission, and ancillary services. Order No. 888, at 31,654-55.

In Order No. 888, FERC also recognized that some utilities were exploring the concept of establishing independent entities to operate transmission facilities in various geographic regions, and sought to encourage "the formation of properly

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[9] *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utlities and Transmitting Utilities*, [1991-1996] FERC Stats. & Regs. (CCH) ¶ 31,306 (1996) ("Order No. 888"), *order on reh'g*, FERC Stats & Regs. (CCH) ¶ 31,048 (1997) ("Order No. 888-A"), *order on reh'g*, 81 F.E.R.C. (CCH) ¶61,248 (1997) ('Order No. 888-B"), *order on reh'g*, 82 F.E.R.C. (CCH) ¶ 61,046 (1998) ("Order No. 888-C"), *aff'd*, *Transmission Access Policy Study Group*, 225 F.3d 667 (D.C. Cir. 2000).

structured ISOs." *Id.* at 31,730-32. FERC therefore articulated eleven standards, regarding issues such as independence, governance, and the degree of operational control, which would guide its approval of proposed ISOs. On review, this court largely affirmed Order No. 888. *Transmission Access Policy Study Group v. FERC*, 225 F.3d 557.

The Creation of ISOs. FERC has approved several ISOs under the Order No. 888 standards. These ISOs were formed by transmission-owning utilities through contracts which establish the rights and obligations of the participants. The structures established by contract may vary, in terms of governance, the degree of operational control, and the initial rate structure. A fundamental issue confronting utilities forming ISOs was the continued recovery of their costs of providing service. The change from a regime in which each utility charges its own rate when transmission crosses multiple systems (which FERC calls rate "pancaking") to a structure of regional pricing tends to reduce revenues, threaten overall cost recovery, and shifts costs among utilities and between wholesale and retail customers. Consequently, in each case the transmission owners voluntarily negotiated acceptable regional pricing structures as a basis for joining ISOs. All of these utilities contemplated that they would retain their section 205 rights to set the rates to their customers. They also contemplated that their contracts would determine the extent to which the ISO would be able to propose changes to the approved tariff under section 205 or be required to propose any such changes under section 206.

FERC has accepted all of the proposed regional pricing structures, but its decisions on section 205 rights have been inconsistent. It approved provisions for NY ISO, *see Central Hudson Gas & Electric Corp.*, 88 F.E.R.C. (CCH) ¶ 61,138 (1999), and Midwest ISO, *see Midwest Independent Transmission System Operator*, 84 F.E.R.C. (CCH) ¶ 61,231, at 62,151 (1988), that preserve certain member utilities' rights regarding rate issues, but denied those rights to the member utilities of the PJM ISO. *See Pennsylvania-New Jersey-Maryland Interconnection,* 81 F.E.R.C. (CCH) ¶ 61,257, at 62,279 (1997), *order on reh'g*, 92 F.E.R.C. (CCH) ¶ 61,282 (2000) ("*PJM*").

<u>Order No. 2000.</u> In the wake of Order No. 888, a substantial number of new participants entered the marketplace – independent and affiliated power marketers and generators and independent power exchanges – resulting in significant growth in the volume of trading in the wholesale electricity market. State regulatory reforms have also affected the way industry participants conduct business. Order No. 2000, at 30,996-97 (JA 404-05). These changes have caused significant stress to the transmission grid, as an increasing number of parties are using the grid in

ways that differ markedly from the uses that prevailed before Order No. 888. Where power flows were fairly predictable before the advent of open access, power now moves along transmission lines in unprecedented volumes and in unexpected directions under conditions for which those facilities were neither planned nor designed. *Id.* at 30,998 (JA 406).

In this environment, on May 13, 1999, FERC issued a Notice of Proposed Rulemaking ("NOPR"). *Regional Transmission Organizations*, *Notice of Proposed Rulemaking*, FERC Stats. & Regs. (CCH) ¶ 32,541, at 33,683-781 (1999). On December 20, 1999, FERC issued its Final Rule in Order No. 2000.

Order No. 2000 was based on two primary areas of concern: engineering and economic inefficiencies in the operation of the transmission grid and continuing opportunities for undue discrimination in the operation of the grid. Order No. 2000, at 31,003, 31,015 (JA 411, 423). Regarding operations, FERC identified problems with the coordination of the utilities' transmission systems in light of increased stresses on the grid from new and different wholesale transactions. FERC also noted difficulties with the calculation of available transmission capacity, with procedures for congestion management, with transmission planning and construction, and with the potential for pancaked transmission rates to restrict the size of regional power markets. *Id.* at 31,004 (JA

412). Regarding discrimination, FERC found that the vertically integrated utilities still had the incentive and the opportunity to favor their generation interests over those of their competitors, notwithstanding the unbundling requirements of Order No. 888. *Id.* FERC did not make any findings of actual discrimination by any electric utility. Rather, it observed that the "perception" of discrimination posed a significant impediment to the development of competitive markets. *Id.* at 31,016-17 (JA 424-25).

FERC viewed the creation of RTOs as the solution to these problems. The RTO would have functional control over transmission facilities within a region larger than the individual service areas of the participating utilities. Under FERC's scheme, the transmission owners would transfer functional control over their facilities to the RTO through various contractual arrangements, and the RTO would then provide jurisdictional transmission services over the facilities that it controls. *Id.* at 31,076 (JA 484).

FERC expects all public utilities to join RTOs. *Id.* at 30,993 (JA 401). By October 15, 2000, jurisdictional transmission owners had to file a proposal to participate in an RTO or explain why it is not participating in an RTO at that time. *Id.* at 31,222-23 (JA 630-31). Transmission owners that are members of existing ISOs must make a filing by January 15, 2001, explaining how the ISO meets the minimum requirements for an RTO and identifying any modifications necessary to the existing structure to conform to the requirements of Order No. 2000. *Id.* at 30,994-95 (JA 402-03).

In Order No. 2000, FERC contemplated that an acceptable RTO can take one of several forms – an ISO, transco, or combinations of the two. Under the ISO model, the RTO will not own transmission assets, but will operate facilities owned by its participating utilities. The participating utilities will retain ownership of the transmission facilities used to provide service to the public and will have to recover their costs through the FERC ratemaking process, just as they have in the past. In addition, the utilities participating in an ISO will continue to physically operate the facilities.[10]

In Order No. 2000, FERC established four minimum characteristics and seven minimum functions for an acceptable RTO. Among other things, the RTO must be independent of any entity whose economic or commercial interests could be significantly affected by its decisions. *Id.* at 31,061 (JA 469). The RTO, its

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[10] A transco, on the other hand, will own some or all the transmission facilities that it controls, and thereby assume physical operations and the public service obligation. Order No. 2000 is neutral as to organizational form, provided that the RTO satisfies the requirements of the Final Rule. *Id.* at 31,037 (JA 445).

employees, and non-stakeholder directors cannot have any financial interests in any market participant. FERC will closely scrutinize the proposed governance structures of each RTO (including stock ownership, voting rights, and boards of directors) to ensure independence. *Id.* at 31,063 (JA 471).

In addition to its requirements for structural independence, FERC promulgated an entirely new ratemaking regime for transmission services provided within the context of RTOs. Historically, public utilities that provided jurisdictional transmission services from their facilities have enjoyed the statutorily protected right to file the proposed rates, terms and conditions for these services under section 205. Under its new RTO regulations, utilities lose their rights to file proposed rate changes under section 205. Rather, the RTO "must have exclusive and independent authority" to make and file all rates for service over its participating utilities' transmission systems, including transmission services that are mandated by Order No. 888. 18 C.F.R. § 35.34(j)(1)(iii) (2000) (JA 818); Order No. 2000, at 31,075 (JA 483).

FERC appears to contemplate a process under which the transmission owner will establish its revenue requirement through a section 205 filing with FERC, and contract with the RTO to recover that revenue requirement. The RTO will have exclusive authority to design and file rates for transmission services to the public.

Order No. 2000, at 31,075 (JA 483). The revenues collected by the RTO will then be returned to the transmission owners. *Id.* at 31,075-76 (JA 483-84). Utilities participating in RTOs are therefore precluded from designing and filing rates under section 205 that will recover their revenue requirements.

Order No. 2000-A. Petitioners, Intervenors, and other parties filed requests for rehearing and clarification of this aspect of Order No. 2000, citing numerous legal errors and the difficulties associated with this novel reformulation of the rate filing process. In particular, transmission owners argued that denying them the right to file the rates under section 205 gravely threatened their ability to recover their costs of providing FERC-jurisdictional services. In Order No. 2000-A, FERC denied rehearing. It brushed aside claims that RTO control over rates was not needed to serve the purposes of the Final Rule by broadly asserting that the need was "clear." Order No. 2000-A, at 31,370 (JA 788). FERC, however, suggested certain possibilities for the protection of the transmission owners' interests. FERC proposed that the transmission owners could extract an "enforceable obligation" from an entity that itself owns little or no assets for payment of their multi-million dollar revenue requirements. *Id.* FERC also suggested that the transmission owners could participate in a pre-filing process and perhaps persuade an RTO with "exclusive and independent" rate filing authority to accommodate their interests.

Id. Finally, FERC noted that although the transmission owners cannot control the filing of the rates needed to recover their revenue requirements, they may intervene in the ensuing proceedings and make whatever arguments they wanted. *Id.* at 31,371 (JA 789).[11]

In response to the adoption of the open architecture rule, NY Transmission Owners sought clarification from FERC that an RTO cannot unilaterally change the essential terms of the RTO enabling agreements (*i.e.*, the agreements transferring control to the RTO). FERC conceded that the transmission owners have a legitimate concern that open architecture places them at risk for being

[11] FERC also noted in Order No. 2000-A that it was not making findings "in this generic proceeding" on the current division of section 205 filing rights for any of the existing ISOs and would do so when the participating utilities submitted their Order No. 2000 compliance filings. FERC added that they "would entertain other approaches to the division of filing authority as long as they ensure the independent authority of the RTO to seek changes in rates, terms, or conditions of transmission service and the ability of transmission owners to protect the level of the revenue needed to recover the costs of their transmission facilities." *Id.* at 31,371 (JA 789). However, FERC did not change the relevant regulation which states that the RTO "must have exclusive and independent authority under Section 205 . . . to propose rates, terms, and conditions of transmission service over the facilities it operates." 18 C.F.R.§ 35.34(j)(1)(iii) (2000) (JA 818). In its only post-Order No. 2000-A decision, FERC rejected a proposal by the PJM ISO supporting companies to retain limited section 205 rights in forming an ISO. *See PJM*, 92 F.E.R.C. (CCH) ¶ 61,282 (2000)

bound to an arrangement that is subsequently modified in such a way that it is fundamentally different from the agreement underlying the creation of the RTO. Although FERC stated that the transmission owners' legitimate concern "must be addressed in any RTO proposal" (Order No. 2000-A, at 31,383; JA 801), FERC did not modify its inconsistent regulation.

Finally, certain transmission owners also requested FERC to clarify the Final Rule to require RTOs to adhere to the statutory requirements of sections 210, 211, and 212 with regard to any RTO-mandated expansions or interconnections. In addition, the transmission owners sought clarification and rehearing that transmission owners will not be required to bear the risk of any potentially uneconomic facilities that the RTO directs them to construct. In response, FERC acknowledged the validity of the transmission owners' concern but did not clarify the Final Rule. Rather, FERC only stated that it "agree[d] that a transmission owner is entitled to compensation for construction undertaken at the directive of an RTO, and . . . expect[ed] that these issues will be resolved systematically by the RTO." Order No. 2000-A, at 31,381 (JA 799).

SUMMARY OF ARGUMENT

FERC erred in prescribing that RTOs must have exclusive and independent authority to file rates for transmission service. As applied to an ISO, this rule removes the owners' discretion under FPA section 205 to form contracts and file rates for transmission services provided over their assets. Abundant precedent holds that, under section 205, FERC reviews filed rates for reasonableness – it has no authority to interfere with the utility's filing of rates in the first instance.

Further, the rule effects a fundamental change in ratemaking without adequate explanation or reasoned consideration of the risks. Departing from more than sixty years of precedent, FERC split the ratemaking process into two parts – owners of transmission assets would file their revenue requirements, but RTOs with independent management would have the exclusive responsibility to design rates that would produce the revenues actually generated. The risk to the owners is obvious – if the rate levels or design filed by the RTOs do not produce adequate revenues, the RTO, which has no significant assets or other sources of funds, would have no ability to compensate the transmission owners.

FERC suggested that the owners could protect themselves through prefiling negotiations with the RTO, but this is illusory in a regime where the RTOs must be independent and represent the interests of customers. FERC also suggested that owners intervene in proceedings to review rate filings by the RTO, but the owners would find themselves with no control over the timing or substance of the rates in issue. They would not be able to propose a rate satisfying their revenue requirements without first proving the RTO's existing rate unjust and unreasonable, a higher statutory burden. In effect, this turns the statute upside down, in that the owners would bear the burden imposed by the FPA on FERC. Worse still, even when that burden was satisfied, FERC would be unable to grant effective relief, since it has no authority to grant retroactive rate increases.

Despite the dramatic departure from longstanding precedent on ratemaking and the huge risks that this scheme would have for utilities and their investors, FERC never provided a coherent explanation of why it was necessary. Order No. 2000 found that there were problems in the management of the grid and suggested that there were continuing incentives for discrimination in operations. These issues are addressed by the formation of an independent RTO exercising neutral control over *operations*, such as access to the grid. But FERC never explained why exclusive and independent authority over *rates* was even relevant to the problems that Order No. 2000 was intended to solve. FERC never found any discrimination in rates, nor could it, for the FPA already requires FERC to ensure that rates filed are nondiscriminatory and FERC's open access rules already require that the same Commission-authorized rates must be applied to all customers, including the utility itself. FERC should have considered whether an ISO with full independence and neutrality with regard to operations, but administering tariffs filed by its owners, would have been a sufficient answer to the problems identified in its rulemaking.

Similarly, FERC's Final Rule unlawfully rewrites the FPA by categorically prohibiting parties, in establishing an RTO, from exercising their statutory right to limit the RTO's ability to propose unilateral rate changes under section 205 and require instead that the RTO file any changes under section 206. FERC did not even attempt to adequately explain the need to do so.

FERC also erred by neglecting to modify its proposed regulations to clarify that the RTO will not have the ability to unilaterally avoid contractual commitments embodied in the RTO enabling agreements. Finally, FERC recognized the validity of transmission owners' concerns that RTO-ordered transmission expansions or interconnections must comply with existing statutory requirements. However, FERC erred by failing to modify its rule and deferring this statutory issue to be addressed in some undefined way in the RTO compliance process.

ARGUMENT[12]

STANDARD OF REVIEW

FERC's order cannot be sustained if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1994). The Court must first independently examine the enabling legislation to determine whether FERC acted within the bounds of its statutory authority. *See In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92 (1968); *Office of Consumers' Counsel v. FERC*, 655 F.2d 1132, 1141-42 (D.C. Cir. 1980). The Court does not defer to the agency's view of its authority if it is at odds with established judicial interpretation of the statute, *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1504 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984), is not consistent with the statutory text and legislative history, *Office of Consumers' Counsel*, 655 F.2d at 1141-42, is unreasonable in light of congressional intent, or raises serious constitutional questions. *Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

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[12] Pursuant to the Court's Order of September 8, 2000, this is a joint brief of Petitioners and Intervenors. Petitioners EEI and the participants in the PJM ISO and Northeast Utilities join in Arguments I, II and III of the brief. The NY

(Continued ...)

If the agency has authority, the Court then conducts a "searching and careful" inquiry into the record in order to assure itself that the agency has given reasoned consideration to each of the pertinent factors and issues before it. *See Farmers Union*, 734 F.2d at 1499-1500; *Public Sys. v. FERC*, 606 F.2d 973, 980 (D.C. Cir. 1979). The requirement for reasoned decision-making is magnified in cases where the issues are complex and the proposed changes are dramatic. *See Great Lakes Gas Transmission Ltd. v. FERC*, 984 F.2d 426, 433 (D.C. Cir. 1993); *Farmer's Union*, 734 F.2d at 1500; *N. C. Utils. Comm'n v. FERC*, 42 F.3d 659, 663 (D.C. Cir. 1994); *Columbia Gas Transmission Corp. v. FERC*, 628 F.2d 578, 586 & n.31 (D.C. Cir. 1979). The court must be assured that FERC has taken a "hard look" at the salient problems of its proposed action and has not disregarded those facts or issues that prove difficult or inconvenient. *See Consolidated Edison Co. v. FERC*, 823 F.2d 630, 637, 642 (D.C. Cir. 1987); *see also Tenneco Gas v. FERC*, 969 F.2d 1187, 1214 (D.C. Cir. 1992).

Transmission Owners join in Arguments I through VI of the brief. Midwest ISO Participants join in Arguments II and III.

I. FERC UNLAWFULLY DEPRIVED TRANSMISSION OWNERS OF THEIR DISCRETION TO FILE TARIFF RATES UNDER FPA SECTION 205

Order No. 2000 prescribes that RTOs will have the exclusive FPA section 205 right to file rates and other terms for the provision of transmission service to customers. In the context of an ISO, this rule deprives the participating, transmission-owning utilities of any ability to design and file the rates governing transmission service to the public over their own facilities. It thereby contravenes the congressional scheme underlying section 205.

Under section 205, each public utility has the right to design and file rates for service to consumers, while FERC's role is limited to review of the rates and other terms for reasonableness. It has no power to direct the filing of a rate unless it has found an existing rate unlawful. *See, e.g., Papago Tribal Util. Auth. v. FERC*, 723 F.2d 950, 952-53 (D.C. Cir. 1983), *cert. denied*, 467 U.S. 1241 (1984). This balance between the public utility's freedom to file rates and FERC's oversight role has been recognized by the U.S. Supreme Court, *see United Gas Pipe Line Co. v. Mobile Gas Corp.*, 350 U.S. 332, 339 (1956); *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956), and zealously guarded by the federal courts of appeal, *e.g., Public Service Comm'n v FERC*, 866 F.2d 487 (D.C. Cir. 1989). FERC's action here requires a similar response.

A. The Federal Power Act Preserves the Utility's Right to Make and File Rate Changes

Section 205 leaves the filing of rates[13] to the discretion of the public utilities with ownership interests in the assets. It does not grant FERC the power to dictate the filing of contracts, rates, or tariffs in the first instance. Rather, the FERC plays "an essentially passive and reactive role" under that section. *City of Winnfield v. FERC*, 744 F.2d 871, 876 (D.C. Cir. 1984) (Scalia, J.). Section 205 recognizes that public utilities may file changes to rates and terms of service at any time upon 60 days' notice. 16 U.S.C. § 824d(d) (1994). FERC can then review those changes under section 205 and suspend them for a period of up to five months, but it can reject them only if it finds that the changes proposed by the public utility are not "just and reasonable." 16 U.S.C. § 824d(e) (1994); *Cities of Campbell v. FERC*, 770 F.2d 1180, 185-86 (D.C. Cir. 1985); *Papago*, 723 F.2d at 952-53.

Although under section 206 FERC can initiate a change in rates or other service terms, it may only do so after first demonstrating that the public utility's rates or other service terms are "unjust, unreasonable, unduly discriminatory or

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[13] In this brief, "rates" is construed broadly to apply to rates, rate schedules, tariffs, terms, and conditions (and amendments thereto) as they may affect the recovery of the costs of providing jurisdictional service.

preferential." 16 U.S.C. § 824e(a) (1994). *See Papago*, 723 F.2d at 956; *Alabama Power Co. v. FERC*, 993 F.2d 1557, 1569 (D.C. Cir. 1993); *Metropolitan Edison Co. v. FERC*, 595 F.2d 851, 855 (D.C. Cir. 1979). FERC must then show that its proposed changes are just and reasonable. *Tennessee Gas Pipeline Co. v. FERC*, 860 F.2d 446, 454 (D.C. Cir. 1988).

These provisions preserve the discretion of the public utility, which has made the investment in the assets, to propose rates. In *Mobile*, where the Court addressed the parallel provisions of the Natural Gas Act ("NGA"), sections 4 and 5,[14] it observed that "[t]hese sections are simply parts of a single statutory scheme under which all rates are established initially by the natural gas companies, by contract or otherwise, and all rates are subject to being modified by the Commission upon a finding that they are unlawful." 350 U.S. at 341. *See also id.* at 343 ("Admittedly, the Act presumes a capacity in natural gas companies to make rates and contracts and change them from time to time . . . ."). As the Supreme

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[14] The Supreme Court has long held that the ratemaking and rate changing provisions of the FPA are in all material respects substantially identical to the provisions of the NGA. *Sierra*, 350 U.S. at 353. Section 205 of the FPA is analogous to section 4 of the NGA; section 206 of the FPA is analogous to section 5 of the NGA. Constructions of one provision are authoritative for the other. *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981).

Court stated in *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*, 358 U.S. 103, 113-14 (1958), the public utility, "like the seller of an unregulated commodity, has the right. . . to change its rates . . . [at] will, unless it has undertaken by contract not to do so."

The balance struck by Congress in this statutory scheme serves an important goal:

> Business reality demands that [public utilities] should not be precluded by law from increasing the prices of their product whenever . . . economically necessary . . .; otherwise procurement of the vast sums necessary for the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible.

Memphis, 358 U.S. at 113. The NGA effectuates this intent by, *inter alia*, "providing in section 4 for the earliest effectuation of contractually authorized or otherwise permissible rate changes," subject to appropriate Commission review. Id. at 113-14. As this court has noted, "[t]he *Sierra-Mobile* doctrine thus defined an arena of freedom of contract within the regulated environment of utility-consumer relations." *Cities of Campbell v. FERC*, 770 F.2d at 1185-86.

In Order No. 2000, FERC destroyed this statutory balance. To effectuate a regime in which transmission owners must cede ratemaking authority to RTOs, FERC mandated that each transmission owner contract exclusively with the RTO, which would then act as a "middleman" arranging service over the public utilities' facilities for the real customers and returning the revenues it collects to the utilities. By relying on a contractual relationship between the transmission owner and the RTO, FERC impermissibly eliminated the privity of contract between the transmission owner and its true customers, and required the transmission owner cede to the RTO its section 205 discretion to make and file changes to the rates for services to the customers. This regime casts aside the balance reflected in the structure of the FPA and implemented in several decades of judicial precedent.

B. FERC Has No Authority Under Section 205 or Section 206 to Deprive a Utility of Its Discretion to Make and File Rates

FERC purported to proceed "[p]ursuant to our authority under Section 205 of the Federal Power Act (FPA) to ensure that rates, terms and conditions of transmission and sales for resale in interstate commerce by public utilities are just, reasonable and not unduly discriminatory or preferential. . . ." Order No. 2000, at 30,993 (JA 401). But nothing in that provision allows FERC to deprive a public utility of its freedom to contract and to file rates. In fact, any such action would plainly be inconsistent with the basic premise of the statutory scheme, discussed in *Mobile*, *Sierra*, and *Memphis*, that the public utility has the right to enter into contracts initially with its customers, and to make changes to those contracts in the first instance. *Cf. Farmers' Union*, 734 F.2d at 1504 ("an agency may not exceed well established judicial interpretation that structures administrative discretion.").

Under section 205, FERC can only determine whether the rates and terms filed by a utility are just and reasonable. *Mobile*, 350 U.S. at 341. The courts of appeals have repeatedly and quite vigorously held that FERC has no power to force public utilities to file particular rates unless the existing rates were first held unlawful. *See Pub. Serv. Comm'n v. FERC*, 866 F.2d at 488-89 ("On four occasions in the last three years this court has reviewed [FERC] efforts to compromise section 5's limits on its power to revise rates. On each the court has repelled [FERC]'s gambit. This is number five."); *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1578 (D.C. Cir. 1993) ("We now make it an even six."); *Consumers Energy Co. v. FERC*, 226 F.3d 777 (6th Cir. 2000).[15] On each occasion, the courts held that FERC must first find existing rates or terms unlawful

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[15] *Accord Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 183 (D.C. Cir. 1986); *Panhandle Eastern Pipe Line Co. v. FERC*, 613 F.2d 1120 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 889 (1980); *City of Willcox v. FPC*, 567 F.2d 394, 402-03 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1012 (1978); *Louisiana v. FPC*, 503 F.2d 844, 861 (5th Cir. 1974).

before directing the filing of different rates.[16] FERC did not even attempt to meet this requirement when it eliminated the utilities' discretion to make and file rates.

FERC has never had and has never needed the power to direct the filing of rates in the first instance. Sections 205 and 206 provide FERC with ample authority to accomplish its primary charge under the FPA – to ensure just and reasonable rates for transmission service. If a utility files a rate under section 205 that FERC determines is unjust or unreasonable, FERC can reject that rate. If FERC approves a rate that subsequently becomes unjust and unreasonable, it can substitute a just and reasonable rate under section 206 upon a showing that the existing rate is now unlawful. This straight-forward approach is all that Congress thought necessary for FERC to exercise effective oversight over rates for jurisdictional services.

But under Order No. 2000, FERC, in effect, swaps places with the utility. It seizes control of the filing of rates under section 205 through its chosen instrument (the RTO) and requires the utility to protect its own cost recovery under the more onerous requirements under section 206. Thus, in order to obtain a rate change, the

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[16] *See, e.g., Sea Robin Pipeline Co.,* 795 F.2d 182; *Tennessee*, 860 F.2d at 454; *Pub. Serv. Comm'n v. FERC*, 866 F.2d 487; *Western Resources*, 9 F.3d 1568.

utility is forced to take up the double burden of proving the RTO's rates unlawful and demonstrating that its proposal is just and reasonable under section 206. By depriving the utilities of the statutory provision that was meant for their protection and imposing upon them the burdens that were imposed by Congress on the Commission, FERC turns the statutory scheme on its head. *Cf. City of Winnfield v. FERC*, 744 F.2d at 875 ("For in that circumstance the agency is effectively using section 205, which is intended for the benefit of the utility . . . for the quite different purpose of depriving the utility of the statutory protections contained in § 206. . . ."). This court "has strictly policed the statutory line that separates action taken" under sections 205 and 206 and their equivalents under the NGA. *"Complex" Consolidated Edison v. FERC*, 165 F.3d 992, 1001 (D.C. Cir. 1999).

Even if FERC had sought to proceed under section 206 and made the requisite findings, it could not have imposed the restrictions contemplated by Order No. 2000. Section 206 authorizes only the substitution of a lawful rate for one found to be not just or reasonable. It does not authorize a prohibition on direct contractual relationships between utilities and their customers. It does not authorize the Commission to take away the utility's right to file new rates in the future pursuant to section 205. In short, section 206 does not authorize the kind of gross infringement on section 205 rights attempted here.[17]

C. FERC Cannot Compensate For the Lack of Statutory Authority By Presenting Its Requirements As "Voluntary"

FERC cannot evade all responsibility for its actions by declaring its entire program "voluntary." First, those transmission owners that joined ISOs years before Order No. 2000 have no practical choice but to adhere to FERC's new requirements regarding the structure of the ISO. FERC has held that, once an ISO began operations, a participating utility cannot simply withdraw from the organization. Before exiting, the utility must first obtain approval under FPA section 203, which requires FERC to make a finding that the withdrawal is in the public interest. *See, e.g., Midwest ISO*, 84 F.E.R.C. (CCH) ¶ 61,231, *order on*

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[17] FERC also cannot rely upon FPA section 202(a). Section 202(a) addresses FERC's ability to encourage voluntary interconnection and coordination of transmission facilities. 16 U.S.C. § 824a(a) (1994). On its face, the provision does nothing more than authorize the agency to set the geographical boundaries for regional groupings of public utilities. Although it expresses the "policy of *promoting* interconnection," *City of Huntington v. FPC*, 498 F.2d 778, 784 n.31 (D.C. Cir. 1974), it does not provide FERC with any substantive powers "to compel any particular interconnection or technique of coordination." *Duke Power Co. v. FPC*, 401 F.2d 930, 943 (D.C. Cir. 1968). *See also Cent. Iowa Power Coop. v. FERC*, 606 F.2d 1156, 1167-68 (D.C. Cir. 1979); *Richmond Power & Light v. FERC*, 574 F.2d 610, 620 (D.C. Cir. 1978).

reh'g, 85 F.E.R.C. ¶ 61,372 (CCH) (1998); *PJM*, 92 F.E.R.C. (CCH) ¶ 61,282 (2000).[18] In Order No. 2000, however, FERC found that the public interest requires that utilities participate in RTOs. Thus, participating utilities in existing ISOs are effectively compelled to remain in the ISOs and comply with the requirements of Order No. 2000.

For transmission owners not in an existing ISO, it is hard to see either Order No. 2000 or its deprivation of section 205 rights as voluntary. FERC has required every public utility either to file an RTO proposal or justify why it has not done so. Once transmission owners join an RTO, they cannot design any structure that will allow them to continue to file rates for service to their customers, nor can they control the RTO's rate filings to ensure recovery of the underlying revenue requirements. As a condition of joining the RTO, they have involuntarily lost their section 205 rights. *Cf. Panhandle Eastern Pipe Line Co. v. FERC*, 613 F.2d 1120, 1129 (D.C. Cir. 1979).

Finally, FERC's concept of "voluntariness" is but a mirage. Although it declined in Order No. 2000 to adopt explicitly a generic policy regarding the

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[18] Petitioners and Intervenors do not address here or waive any existing contractual rights they may have under existing agreements.

imposition of sanctions on public utilities that declined to participate in RTOs in Order No. 2000, FERC noted its authority to require membership in an RTO as a condition for approving mergers and other corporate restructurings, which are essential for reducing costs and improving service to customers. FERC also noted that it would make grants of authority to charge market-based rates – essential to competition in the wholesale marketplace – contingent on RTO membership. The inability to obtain those approvals could prove fatal to any public utility in the new regulatory environment. This court has refused to accept an assertion of power based on voluntariness where it was apparent that the public utility had little choice but to accept FERC's program. *See Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1024 (D.C. Cir. 1987) ("when a condemned man is given the choice between the noose and the firing squad, we do not ordinarily say he has 'voluntarily' chosen to be hanged."), *cert. denied*, 485 U.S. 1006 (1988).

II. FERC FAILED TO GIVE REASONED CONSIDERATION TO THE RISK THAT THE TRANSMISSION OWNER WOULD NOT BE ABLE TO COLLECT ITS REVENUE REQUIREMENT

In mandating that RTOs will exercise independent section 205 tariff-filing rights with respect to transmission services provided with the assets of the member utilities, FERC has failed to engage in reasoned decision-making and has reached an indefensible outcome. Without evident acknowledgement of the enormity of its action, FERC abandoned decades of ratemaking practice and imposed a new and untested regime. As the *Mobile-Sierra* cases suggest, the ability to file rates under section 205 has always rested with the owner of the transmission assets because only the owner has made investments in the facilities that have been dedicated to the public good and only the owner has an economic interest in recovering the costs of those investments plus its operating expenses. FERC, however, has given exclusive authority for the design of rates to the RTOs, while leaving the entire risk of nonrecovery on the owners of the transmission assets. FERC failed to consider the grave risks to the transmission owners of these changes to their ability to recover their costs. Its ratemaking procedures are unworkable and its "protections" for the utilities' revenue streams are wholly ineffective. FERC's failure to consider the consequences of its action requires that its decision be vacated.

A. FERC Effected a Dramatic Change in Its Longstanding Ratemaking Process Without Adequate Explanation

Order No. 2000 effects a radical change in the ratemaking process. Historically, determination of revenue requirements and rate design have always been components of a single process encompassed in the section 205 tariff filing. As FERC explained:

> The rate making process begins with the establishment of a cost of service or revenue requirement, continues through a series of steps by which costs are assigned to

> various services and customer groups and concludes with the development of unit rates. The establishment of a cost of service thus of necessity links rate design to costs.

Interstate Natural Gas Pipeline Rate Design, 47 F.E.R.C. (CCH) ¶ 61,295, at 62,052 (1989). *See also* James C. Bonbright, *et al.*, *Principles of Public Utility Rates* 373 (2d ed. 1988) ("the distinction between rate-level and rate-structure is one of convenience rather than of analytical logic"); A.E. Kahn, *The Economics of Regulation* 26 (1988) ("discussions of rate levels are really discussions of total revenues."). In over 60 years of administering the FPA, FERC and its predecessor, the Federal Power Commission ("FPC"), have never before attempted to separate responsibility for rate design from responsibility for revenue requirements.

In Order No. 2000, FERC assigned these aspects of ratemaking to different entities. The final regulation specifies that the RTO "must have exclusive and independent authority under section 205 . . . to propose rates, terms and conditions of transmission service provided over the facilities it operates." 18 C.F.R. § 35.34(j)(1)(iii) (2000) (JA 818). In a "note" added after the regulation was initially proposed, FERC stated that "transmission owners retain authority under section 205 . . . to seek recovery from the [RTO] of the revenue requirements associated with the transmission facilities that they own." *Id.* The consequences of this unprecedented and haphazard separation of authority were not adequately considered or addressed by FERC.

The Final Rule destroys the essential connection between the transmission owners' revenue requirements and the design of the rates intended to produce those revenues. The owners are therefore wholly at risk for any return on their assets. This is a much more serious question than the risk associated with the collection from a single consumer, for the *entire* revenue stream of the transmission owner must now be generated through rates over which it has no control. Control over the revenue requirement that it can collect from the RTO alone is not adequate to assure financial security. If there are insufficient revenues generated by the RTO from the customers using the transmission system, a revenue requirement is essentially meaningless. An RTO that does not own transmission assets can offer no security, leaving the transmission owners dependent on whatever rates the RTO proposes under section 205.

FERC's dramatic departure from 65 years of consistent ratemaking practice requires a cogent explanation – one that assesses both the need for change in the ratemaking arena and the likely effects of that change. "The Commission bears the burden of explaining the reasonableness of any departure from a longstanding practice . . . ." *Columbia Gas Transmission Corp. v. FERC*, 628 F.2d 578, 586 &

n.31 (D.C. Cir. 1979). FERC must provide "its assessment of the consequences of its orders for the character and future development of the industry." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968). It must show that it has "gauged the likely effects of its course" on the industry and its customers. *Pub. Sys. v. FERC*, 606 F.2d 973, 981 (D.C. Cir. 1979). In this instance, FERC failed either to give reasoned consideration to the consequences of its change or to come up with a compelling justification.

B. FERC's Scheme Unreasonably Jeopardizes The Utility's Ability to Recover Its Costs of Providing Jurisdictional Service

FERC had both a statutory and a constitutional obligation to examine carefully the financial consequences of its fragmentation of the ratemaking process. The just and reasonable rate required by the FPA must be "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). *See also Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (*en banc*) (the *Hope* standard "defines the point at which a rate becomes unconstitutionally confiscatory as well"). It is not simply the *rate* of return that must be adequate to assure confidence in the company's financial integrity, but also the *security* of that return. "Low, uncertain or irregular income makes for low prices for the securities of the utility and higher rates of interest to be demanded by investors." *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 694 (1923). "[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated." *Hope*, 320 U.S. at 603.

Here, FERC has, without reasoned consideration, jeopardized the financial integrity of the transmission owners participating in an ISO. It has placed them in a posture where their returns are so uncertain as to call into question their ability to maintain credit and attract additional capital. The *sole* source of all their revenues with respect to *all* of their transmission assets will be an independent entity with a management that represents other constituencies and interests. That entity will have little or no assets of its own and no credit history. Revenues received by the transmission owner will be wholly determined by the rates developed and filed by the RTO. The RTO will make all the decisions about when, where, and how the owners' filed revenue requirement will be recovered. Even if the revenue requirement were to impose a non-conditional obligation of the RTO to pay a sum certain (regardless of revenues generated), it would offer no protection beyond a simple pass-through, because the RTO has no independent assets with which to fulfill the contract. Of course, the transmission owner might then be able to put the

RTO into bankruptcy, but this outcome will not be of much benefit to either the public or the transmission owner.

It is difficult to comprehend a situation more fraught with inherent conflict than one where the entity that has been formed to represent primarily the interests of transmission customers is given exclusive authority to establish the rates relied upon by transmission owners to recover their costs. Petitioners are unaware of any other situation in which multi-billion dollar businesses have involuntarily relinquished control over their assets to another, completely independent entity, and further relinquished all ability to set prices for the use of those assets. Certainly, the huge financial risk inherent in this structure was not adequately addressed by the Commission.

C. FERC's Suggestions to Protect the Utility's Revenue Streams Do Not Reflect Reasoned Decisionmaking

When petitioners raised these concerns, FERC responded in Order No. 2000-A with three suggestions. FERC posited that: (1) transmission owners could enter into "contractually enforceable obligations" with the RTO, Order No. 2000-A, at 31,370 (JA 788); (2) transmission owners could "participat[e] in the RTO's designing of rates to transmission customers, as long as they are not given veto authority over, or otherwise control, what the RTO ultimately seeks to file under Section 205," *id.*; and (3) transmission owners may intervene in the rate proceedings initiated by the RTOs and "make whatever arguments they wish." *Id.* at 31,371 (JA 789). These suggestions are mere palliatives, none of which reflect reasoned decisionmaking.

1. "Contractually Enforceable Obligation"

FERC first suggested that, in order to assure recovery, the transmission owners could rely on the agreement establishing the RTO: "For example, they may provide for a contractually enforceable obligation for the RTO to pay the owners their full revenue requirement as determined by the Commission. . . ." Order No. 2000-A, at 31,370 (JA 788). As noted above, a contract with the RTO to pay a sum certain adds no financial security if, upon breach, the RTO is unable to pay. The dollars available for payment will depend upon the rate levels and design. In the event the RTO failed to file rates at a level sufficient to satisfy the transmission owners' revenue requirements, FERC has not explained how, in light of existing precedent, it would have authority to order the RTO to implement higher tariff rates and pay reparations. *See Montana-Dakota Utils. Co. v. W. Pub. Serv. Co.*, 341 U.S. 246, 254 (1951) (no reparations power); *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (filed rate doctrine precludes award of damages for breach of contract equal to retroactive tariff increase).

2. Pre-Filing Participation in Rate Design

In the alternative, FERC suggested that the transmission owners could try to protect their revenue stream by "participating in the RTO's designing of rates." Order No. 2000-A, at 31,370-71 (JA 788-789). However, FERC never explained how such participation could work in conjunction with the requirement of complete independence in governance, see Order No. 2000 at 31,061-31,073 (JA 469-81), or with the RTO's "independent and exclusive authority" to file tariff rates. A key premise of Order No. 2000 is that the RTO's managers will have different objectives and incentives – focusing on the interests of transmission customers. The RTO has no obligation to accept or even consider any of the transmission owners' suggestions. Its actions may be subject to attack by third parties or FERC if it appears unduly attentive to the transmission owners' interests. In short, FERC cannot have it both ways: it cannot require that the RTO must exercise independent judgment over ratemaking, and at the same time speculate that the transmission owners will be able to exercise significant influence over the RTO's rate design. *Cf N.C. Utils. Comm'n*, 42 F.3d at 666 ("We question how FERC can have it both ways.").

3. Transmission Owner As Intervenor

Finally, FERC suggests that transmission owners will be able to protect their revenue streams by participating in the RTO's rate proceedings before FERC, at which they "will be able . . . to make whatever arguments they wish regarding appropriate rate design and the effect on their recovery of costs." Order No. 2000-A, at 31,371 (JA 789). This suggestion creates a completely unworkable procedure, which would make a shambles of ratemaking, while failing to protect the transmission owners.

FERC's suggestion appears to contemplate two sets of proceedings, one set in which the transmission owners will file their individual revenue requirements, and the other in which the RTO will file tariff rates with respect to all transmission customers. Thus, the transmission owners – the principals with a true economic stake – would be reduced to participate, if at all, as intervenors with section 206 rights in the proceedings following the RTO's section 205 filing that determine how much the transmission customers will pay the RTO.

Participation as an intervenor, rather than as the proponent of the section 205 filing, will have significant adverse consequences for the transmission owners. Importantly, the transmission owners will not be able to initiate the rate proceeding; to control either the proposed rate or rate design; or to determine the timing of any rate change proceeding.

Denying transmission owners "the power to propose" rates directly threatens the recovery of their revenue requirements. As the courts have recognized, there is no single just and reasonable rate; rather, rates that fall within a "zone of reasonableness" will meet the statutory standard. *See Permian Basin Area Rate Cases*, 390 U.S.at 797; *Massachusetts Dep't Pub. Utils. v. FERC*, 729 F.2d 886, 888 (1st Cir. 1984) (the provisions of the FPA "allow the utility the choice among various reasonable rate practices"). FERC is "not required to find that the proposed rate is the 'best' or 'superior' to all others in order to adopt it." *Am. Elec. Power Serv. Corp.*, 44 F.E.R.C. (CCH) ¶ 161,206, at 61,749 (1988) (footnote omitted). If the transmission owner believes the RTO's selected rate design will not result in the recovery of its individual revenue requirements, it must show under section 206 that the RTO's rate design is unjust and unreasonable before suggesting any other rate design. Even though the owner may be able to design a rate structure that is *both* just and reasonable *and* sufficient to recover its revenue requirements, the transmission owner would not be able to propose that rate structure without first showing that the RTO had filed a rate which is unjust and unreasonable. This high hurdle will effectively block the transmission owner in proposing appropriate rates for the use of its own facilities.

Moreover, even if the transmission owner as intervenor demonstrated that a higher rate was justified, FERC could not grant full and effective relief. FERC's authority in response to a section 205 rate filing is limited to "acceptance (in whole or in part) or rejection of the pipeline's proposed rates." *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 183 (D.C. Cir. 1986). FERC would have no power to substitute a rate higher than the one proposed. *See Panhandle Eastern Pipeline Co.*, 613 F.2d at 1129. At the same time, "the Section 206(a) 'power is limited to prescribing the rate "to be thereafter observed" and thus can effect no change prior to the date of the order.'" *Papago Tribal Utility Authority*, 610 F.2d at 925 (quoting *FPC v. Sierra Pac. Power Co.*, 350 U.S. at 353). For these reasons, "a rate for one class or zone of customers may be found by the Commission to be too low, but the company cannot recoup its losses by making retroactive the higher rate subsequently allowed." *FPC v. Tennessee Gas Transmission Co.*, 371 U.S. 145, 152-53 (1962). *Accord Arkansas La. Gas Co.*, 453 U.S. at 578.

Thus, during the entire pendency of the proceeding, transmission owners would be denied any opportunity to recover their revenue requirements. By the time that the initial proceeding is completed, and the RTO is required to file new, compensatory rates, it will be too late to make up retroactively for the under-recovery of costs in the initial rate proceeding. In addition, the RTO may decide to rely on a different rate design, which in turn may be unsatisfactory to the same or other transmission owners, and the process may begin again. Because of the possibility for multiple proceedings, and the fact that the RTO controls the timing and course of such successive section 205 rate filings, transmission owners run the risk of *never* recovering from deficiencies in the RTO's rate design.

All of this flies in the face of the command of section 205 that a public utility's rate proposal will become effective after 60 days' notice, subject to refund, unless suspended by FERC for a maximum period of five months. 16 U.S.C. § 824d(d)-(e). Congress intended that public utilities have an assurance that their rate proposals would become effective promptly, unless found to be unlawful. FERC's unnecessary bifurcation of the tariff filing process would undermine the statutory scheme and would leave public utilities without any assurance of collectible rates for years.

In addition to these problems with litigation over rate design, the second proceeding contemplated by FERC – the transmission owner's filing of its revenue requirements – is also problematic. Under section 205, the proposal for an increased revenue requirement must become effective after 60 days' notice, possibly subject to refund. If the RTO believes that the proposed revenue requirement is unreasonable and refuses to change its rate design to accommodate the increase, it seems doubtful that the RTO could be required to file a different rate design. Litigation over the revenue requirement could continue for several years before the revenue increase is reflected in the RTO's rates. The result would be that the transmission owners would be denied any opportunity to collect the increased portion of its revenue requirement for that period of time. FERC never considered these issues when it blithely suggested that participation in this bifurcated rate proceeding would assure the security of the transmission owners' revenue streams.

Finally, FERC failed to consider the interaction of its bifurcated ratemaking process with other recent rate innovations. For example, in Order No. 2000, FERC encouraged RTOs to develop performance-based ("PBRs"). Order No. 2000, at 31,183 (JA 591). FERC did not explain how this could occur when the compensation of the transmission owners was based on their revenue requirements alone and they had no role in rate design. For PBRs to be effective, the transmission owner whose performance is being gauged must in the first instance have the ability to propose the incentive levels or performance measures, especially since the RTO has no incentive to push for these new rate forms as it does not own the transmission assets. To the contrary, the RTO may be prevented by pressure from its other stakeholders – the transmission service customers – from any innovate rate structure that could increase transmission rates in the short-term. This failure to consider how PBRs would be implemented in a bifurcated ratemaking process is another sign that FERC's division of filing rights was not the result of reasoned decisionmaking.[19]

"It most emphatically remains the duty of this court to ensure that an agency engage the arguments raised before it – that it conduct a process of *reasoned* decisionmaking." *K.N. Energy, Inc. v. FERC*, 968 F.2d 1295, 1303 (D.C. Cir. 1992) (emphasis added). This court has also emphasized that "a court cannot affirm simply because each of the component decisions of [the agency's] order,

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[19] In Order No. 888, FERC provided that transmission owners can design wholesale transmission service rates to recover stranded costs from customers, *see* 18 C.F.R. § 35.26 (2000); Order No. 888 at 31,850-51, and this Court affirmed. *Transmission Access Policy Study Group*, 225 F.3d at 701. But FERC has not explained in Order No. 2000 how the RTO will handle this aspect of cost recovery in the design of its rates, nor what opportunity (if any) the participating utilities will have to fully recover those costs.

Similarly, FERC did not address how a regime so hostile to recovery of the costs of transmission assets would be effective in attracting additional investment in transmission systems – a stated goal of FERC. Order No. 2000, at 31,024-25 (JA 432-33).

taken in isolation, was permissible; it must be the case 'that they do not *together* produce arbitrary or unreasonable *consequences*.'" *Jersey Cent.*, 810 F.2d at 1177 (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968)). In light of the enormous potential impact on the financial soundness of the transmission owners, FERC's failure to give reasoned consideration to the likely adverse consequences of its rule constitutes reversible error.

III. FERC WRONGLY ASSUMED THAT RTOS NEEDED EXCLUSIVE FILING RIGHTS TO ACHIEVE THE STATED GOALS OF ORDER NO. 2000

Notwithstanding the far reaching consequences of FERC's decision for the coherence of the ratemaking process and the financial stability of the transmission owners, FERC never explained why its reassignment of rate filing powers was needed to achieve the goals underlying the Final Rule. Its failure to "state a reasonable basis for its decision" constitutes reversible error. *Transcontinental Gas Pipe Line Corp. v. FERC*, 907 F.2d 1211, 1212 (D.C. Cir. 1990).

In Order No. 2000, FERC articulated two primary objectives. The first goal was to assure better regional management of the grid. Order No. 2000, at 31,003-04 (JA 411-12). Since the implementation of open access transmission, FERC had identified certain engineering and economic inefficiencies inherent in the current operation and expansion of the grid. For example, FERC found that it was becoming increasingly difficult for individual utilities to calculate the amount of available transmission capacity because of the need to obtain timely information from numerous transmission providers. *Id.* at 31,004 (JA 412). FERC also determined that the transmission owners' current methods for managing congestion did not optimize regional relief. *Id.* By creating an RTO with responsibility for various operational functions, FERC addressed the problems it had identified. A radical restructuring of the ratemaking process was not necessary to achieve that goal. Indeed, FERC never mentioned any connection between inefficiencies in the operation of the grid and its rearrangement of the ratemaking process.

The second goal identified as a basis for Order No. 2000 was the curtailment of continuing opportunities for discrimination in the operation of the transmission grid. *Id.* at 31,004-05 (JA 412-13). Relying on perceptions (rather than actual findings), FERC suggested that vertically integrated utilities retained the incentive to use their transmission assets to favor their own generation. *Id.* at 31,004 (JA 412). FERC therefore proposed the RTO as a remedy for potential discrimination in the operation of the grid. The RTO was designed to make the wholesale transmission marketplace transparent in terms of information and equitable in terms of access to the grid. *Id.* at 31,005 (JA 413).

Again, the establishment of RTOs with operational independence accomplished FERC's objective. FERC did not have to deprive the member utilities of their section 205 filing rights to achieve its desired results, and it never articulated a reasonable explanation for requiring the member utilities to transfer those rights to the RTO.

Nor could it. FERC never identified a problem with the member utilities' existing rates or rate designs. In Order No. 2000, there is not a single piece of evidence, much less substantial evidence, of discrimination in rates. Because all rates for transmission service are subject to Commission review, and FERC's Order No. 888 requirements are based on the principle of "comparability," under which all customers receiving transmission service pay a similar rate for service under the utility's OATT, there is no opportunity to discriminate based on rates. Moreover, FERC did not find that the participating utilities' existing rates were unreasonable when it decided that those rates will become part of the RTOs' initial pricing structures. Thus, depriving the participating utilities of their section 205 filing rights is not related to the underlying concern of potential discrimination in operations.

On rehearing, petitioners questioned the need for fundamental change in ratemaking procedures in order for FERC to achieve its objectives of better management and nondiscriminatory access to the grid. FERC responded: "We think the need to be clear. If the RTO does not have the independent right to seek appropriate changes, it is difficult to see how that RTO could be viewed as providing a transmission service that is independent from market participants." Order No. 2000-A, at 31,370 (JA 788).

This statement is an empty shell. On its face, it is circular and contains no evidence. It does not explain whose "view" is being taken into account, or why radical shifts in statutory processes should be determined based on the "views" as opposed to concrete facts. At best, it suggests that independence in ratemaking enhances someone's view of independence. Even accepting this interpretation, it does not explain why the perception of independence in ratemaking is of any importance to neutrality in the operation of the grid – the critical issue before FERC.

In the Final Rule, FERC promulgated a plethora of rules to ensure the neutrality of the RTO in its management of the grid. Nowhere in the orders under review did FERC attempt to explain why these structural requirements for RTOs – coupled with FERC's continuous oversight – were insufficient to achieve independence or the perception of independence in operations. Nor did it explain why the additional step of depriving transmission owners of the right to file rate changes under section 205 would even be helpful in dealing with operational issues. FERC failed to draw "a rational connection between the facts found and the choice made." *Motor Vehicle Mftrs. Ass'n, of United States, Inc. v. State Farm Automobile Ins. Co.*, 463 U.S. 29 (1983); *see also N.C. Utils. Comm'n.*, 42 F.3d at 663.

FERC could have achieved its objectives without forcing the member utilities to cede their section 205 filing rights to the RTO. For example, the RTO, as the exclusive "booking agent" for its participating transmission owners, could determine available transmission capacity, accept reservations, schedule service, confirm transactions, and perform other functions designed to assure equal access to the grid. This would address the underlying problems identified in Order No. 2000, even if the RTO and the participating utilities each retained authority to propose and file changes to their rates and tariffs. The initial ISO proposals were formulated along these lines with transmission owners managing to structure independent entities while maintaining their section 205 filing rights. But FERC rejected these practical – and considerably less drastic – alternatives and thereby failed to meet its obligation to provide a reasoned explanation of why those alternatives, exemplified by the existing ISO agreements, were not sufficient to achieve its goals. *Farmers Union Cent. Exch.*, 734 F.2d at 1511 ("It is well established that an agency has a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives.") (footnote omitted); *International Ladies' Garment Workers' Union v. Donovan*, 722 F.2d 795, 815 (D.C. Cir. 1983), *cert. denied*, 469 U.S. 820 (1984). *See also Yakima Valley Cablevision, Inc. v. FCC*, 794 F.2d 737, 746 & n.36 (D.C. Cir. 1986) ("The failure of an agency to consider obvious alternatives has uniformly led to reversal.").

FERC, in its effort to create centralized bureaucracies that were totally independent of any economic stakeholder, failed to adhere to the most basic principles of administrative law. FERC did not provide reasoned explanations for its decisions, failed to establish rational connections between the problems it identified and its solutions, and failed to examine reasonable existing alternatives. A radical redistribution of ratemaking authority must be supported by a more compelling justification.

IV. FERC ERRED BY CATEGORICALLY PROHIBITING RTO PROPOSALS WHEREBY THE PARTIES LIMIT BY CONTRACT THE RTO'S ABILITY TO MAKE UNILATERAL TARIFF MODIFICATIONS UNDER SECTION 205.

In clarifying the Final Rule with respect to the section 205 filing rights required for all proposed RTO's, FERC stated that any RTO proposal that it would entertain must ensure that the RTO has the independent authority to seek changes in rates, terms or conditions of transmission service. Order No. 2000-A. at 31,370 (JA 788).

In this regard, the Final Rule simply cannot be reconciled with the *Mobile-Sierra* doctrine, under which "parties may determine for themselves when and how existing rates may be altered, subject to FERC's power to adjust rates in the public interest." *Cities of Bethany v. FERC*, 727 F.2d 1131, 1142 (D.C. Cir.), *cert denied*, 469 U.S. 917 (1984). As articulated by the Supreme Court, the statutory framework underlying the *Mobile-Sierra* doctrine ensures that contracts between the parties control whether the service provider has the right to make Section 205 filings or is relegated to Section 206. As this court has noted, "The *Sierra-Mobile* doctrine thus defined an arena of freedom of contract within the regulated environment of utility-consumer relations." *Cities of Campbell v. FERC*, 770 F.2d at 1185-86.

The *Mobile-Sierra* doctrine provides contracting parties with the option to adopt three different contractual arrangements:

> First, the parties may agree that new rates can be unilaterally and immediately imposed by the utility, subject, under § 205, to Commission suspension for no longer than five months, and to ultimate Commission disallowance if they are not just and reasonable. Second, by broad waiver, the parties may eliminate both the utility's right to make immediately effective rate changes under § 205 and the Commission's power to impose

> changes under § 206, except the indefeasible right of the Commission under § 206 to replace rates that are contrary to the public interest. . . . Third, the parties may contractually eliminate the utility's right to make immediately effective rate changes under § 205 but leave unaffected the power of the Commission under § 206 to replace not only rates that are contrary to the public interest but also rates that are unjust, unreasonable, or unduly discriminatory or preferential to the detriment of the contracting purchaser.

Papago Tribal Util. Auth., 723 F.2d at 953 (footnote omitted).

The ability of the parties to agreements establishing an RTO to include provisions delineating section 205 filing rights is of vital importance, as it permits the parties to determine which standard of review will be applied by FERC to future tariff changes once the RTO is established and approved by FERC. It also allows the parties to allocate the burden of proof with respect to proposed changes. Unilateral tariff changes submitted by an RTO under section 205 would be reviewed by FERC to determine only whether the RTO has demonstrated that its proposed changes to the approved RTO tariff are among the many potentially just and reasonable results. In contrast, to the extent the RTO is precluded from *unilaterally* changing the approved tariff under section 205, it would be required to propose any unilateral changes only under section 206. Section 206 would require the RTO to *first* demonstrate that the previously approved tariff is no longer just and reasonable, and then also demonstrate that the tariff changes that it proposes are just and reasonable. These important distinctions underlying the statutory framework, are well settled.[20] FERC cannot write these statutory requirements out of the FPA through use of its rulemaking authority.

The right to determine section 205 filing rights by contract is of critical importance in this case. Transmission owners will retain ownership but transfer operational control of tens of billions of dollars of transmission facilities to RTO's under certain specified and agreed upon terms and conditions under which the RTO will provide service to all transmission owners on behalf of their native loads. The transmission owners owe their customers, shareholders and bondholders a duty to ensure that the RTO structure protects their vital interests. One important vehicle to fulfill those duties is to ensure that the tariffs agreed upon, and approved by FERC, cannot be unilaterally changed by the RTO under § 205 and to require instead that the RTO demonstrate to FERC's satisfaction under section 206 that the

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[20] *See, e.g.*, *Consolidated Edison Co. v. FERC*, 165 F.3d 992 (D.C. Cir. 1999); *Western Resources*, 9 F.3d 1568; *Algonquin Gas Transmission Co. v. FERC*, 948 F.2d 1305 (D.C. Cir. 1991); *East Tennessee Natural Gas Co. v. FERC*, 863 F.2d 932 (D.C. Cir. 1988); *Tennessee Gas Pipeline Co.*, 860 F.2d 446; *Sea Robin Pipeline Co.*, 795 F.2d 182; *ANR Pipeline Co. v. FERC*, 771 F.2d 507 (D.C. Cir. 1985); *N. Y. Pub. Serv. Comm'n v. FERC*, 642 F.2d 1335 (D.C. Cir. 1980), *cert. denied*, 454 U.S. 879 (1981).

previously approved RTO tariff is unjust and unreasonable. The transmission owners cannot be expected, or required, to relinquish to the RTO control over their facilities and the right to provide service, thereby becoming customers of the RTO, without retaining these important contractual rights embodied in the statutory framework of the FPA.

FERC has not even offered any explanation for such a drastic restructuring of the parties' statutory rights. Indeed, it is inconsistent with FERC's Order which rejects the notion of a "cookie-cutter' approach to the formation of RTO's. To the extent that transmission owners and/or customers vest greater authority in one particular RTO, it may be entirely reasonable and appropriate for the parties to limit the RTO's ability to make unilateral tariff changes under section 205 and to require any such changes to be made under section 206. FERC cannot reach that determination in the abstract without due consideration of all relevant facts. Moreover, FERC has offered no cogent explanation to support the requirement that RTO's be permitted to propose changes to the FERC-approved RTO tariff under section 205 rather than under section 206.

Therefore, the court should reverse and remand this aspect of the Final Rule with appropriate instructions that FERC modify its Final Rule to recognize the rights of parties to file RTO proposals that are consistent with their freedom to contract as articulated in the *Mobile-Sierra* doctrine. Such a ruling will foster rather than hinder the objectives of FERC underlying its Final Rule.

V. FERC ERRED IN NEGLECTING TO MODIFY ITS OPEN ARCHITECTURE REGULATIONS TO BE CONSISTENT WITH ITS FINDINGS IN ORDER NO. 2000-A

Order No. 2000 required that the RTO have the "flexibility to unilaterally propose changes to its enabling agreements to meet changing market organization and policy needs." Order No. 2000, at 31,170 (JA 578) (emphasis added).[21] FERC describes this as its "open architecture policy." More specifically, Section 35.34(*l*)

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[21] As codified in new section 35.34(*l*) of the regulations, the open architecture rule provides that:

> (1) Any proposal to participate in [an RTO] must not contain any provision that would limit the capability of the [RTO] to evolve in ways that would improve its efficiency, consistent with the requirements in paragraphs (j) and (k) of this section.
>
> (2) Nothing in this regulation precludes an approved [RTO] from seeking to evolve with respect to its organizational design, market design, geographic scope, ownership arrangements, or methods of operational control, or in other appropriate ways if the change is consistent with the requirements of this section. Any future filing seeking approval of such changes must demonstrate that the proposed changes will meet the requirements of paragraphs (j), (k) and (l) of this section.

18 C.F.R. § 35.34(*l*)(1) (2000) (JA 821).

of FERC's regulations attached to Order No. 2000 states, in part, that "[a]ny proposal to participate in [an RTO] must not contain any provision that would limit the capability of the [RTO] to evolve in ways that would improve its efficiency, consistent with the requirements in paragraphs (j) and (k) of this section."[22] Paragraphs (j) and (k) require the RTO to satisfy four characteristics and eight functions, covering a broad range of topics.

In requests for rehearing, NY Transmission Owners argued that FERC's open architecture policy was over-broad and not reasonable. Transmission owners must enter into enabling agreements with RTOs to form RTOs. These agreements will set forth the terms and conditions under which utilities turn over control of their transmission systems, which are valued at billions of dollars, to RTOs. As the transmission owners argued, it is both reasonable and prudent to place contractual limits on how the RTO will exercise control over and use these assets.[23] To do otherwise, would not meet the transmission owners' fiduciary duties to their

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[22] *Id.*

[23] *See also* Section IV, *supra.*

stockholders and contractual duties to their bondholders.[24] Of course, FERC would have authority to review these limitations in RTO enabling agreements under applicable statutory and judicial standards.

On rehearing, transmission owners argued that the open architecture policy required modification because, upon entering into an RTO agreement, the RTO could modify the agreement without the transmission owners' consent on core fundamental points. For example, the RTO could unilaterally modify reasonable protections that the transmission owners relied on as essential consideration in transferring significant control over their assets to the RTO.

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[24] Utility officers and directors have the statutory as well as fiduciary duty to oppose restructuring models that would likely result in a loss of corporate assets, a substantial diminution of their value or a material impairment of investors' security in such assets, especially when the elements of such models lack a statutory basis, like ceding section 205 rights. *See, e.g.*, New York Business Corporation Law Sections 715(h) and 717(a) (which apply to New York investor-owned utilities by virtue of Transportation Corporations Law Section 4(a)) which provide that an officer or director shall perform his or her duties in good faith and with that degree of care which an ordinary prudent person in a like position would use under similar circumstances (utilities in New York State are incorporated pursuant to the Transportation Corporations Law, Section 3). No prudent businessman would transfer operational control of its assets to another entity and give it a blank check to modify that arrangement as FERC envisions.

In Order No. 2000-A, FERC concluded that the transmission owner concerns regarding the open architecture policy were valid. FERC found as follows:

> On rehearing, some transmission owners restate their concern that open architecture places them at risk for being bound to an arrangement that is fundamentally different from the one they agreed to join. We believe that this is a *legitimate concern that must be addressed in the RTO proposal.*

Order No. 2000-A, at 31,383 (JA 801) (emphasis added).

FERC, however, failed to modify the categorical ban in section 35.34(l) of the regulations on limitations on the RTO's ability to modify its enabling agreement with the transmission owners. This omission is inconsistent with the Commission's findings in Order No. 2000-A quoted above. The Commission clearly stated that RTO proposals must address the transmission owners' "legitimate concern" that they not be "bound to an arrangement that is fundamentally different from the one they agreed to join." The only effective means of addressing this issue is through reasonable limitations in RTO authority to modify fundamental transmission owner rights and RTO obligations in enabling agreements.

Correcting the regulations on the open architecture policy will avoid a chilling effect on the formation of RTOs in the future by providing transmission owners with reasonable assurances that the "rules of the game" will not be substantially altered subsequent to the voluntary relinquishment of control over transmission assets to the RTO. Transmission owners will have transferred control over their assets in exchange for certain safeguards set forth in the agreements under which control was transferred. If left uncorrected, the regulation's open architecture provision would seriously erode transmission owner reliance on these safeguards because they may later be modified or eliminated altogether under the guise of permitting an RTO to "evolve."

FERC's failure to modify its open architecture regulation (18 C.F.R. § 35.34(*l*); JA 821) was arbitrary, capricious, not reasoned decisionmaking, and not otherwise in accordance with law. *City of Dothan v. FERC*, 684 F.2d 159, 164 (D.C. Cir. 1982); *City of Vernon v. FERC*, 845 F.2d 1042, 1046 (D.C. Cir. 1988). The Court should reverse and remand this portion of the Final Rule with instructions that FERC modify the open architecture regulation to be consistent with FERC's holding in Order No. 2000-A so that reasonable limitations in unilateral modification of RTO enabling agreements will be honored.

VI. FERC ERRED BY FAILING TO RECOGNIZE AND AFFIRM THE TRANSMISSION OWNERS' STATUTORY RIGHTS IN CONNECTION WITH TRANSMISSION EXPANSIONS OR INTERCONNECTIONS UNDER THE RTO STRUCTURE.

The Final Rule approved by FERC accords RTOs the "ultimate responsibility for planning, and for directing or arranging, necessary transmission expansions, additions and upgrades within its region. . . ." Order No. 2000-A, at 31,380-81 (JA 798-99). While FERC expressly recognized the important interests of transmission owners in the statutory protections afforded by sections 210, 211, and 212 with respect to RTO-mandated expansions and interconnections (Order No. 2000-A, at 31,381; JA 799), it failed to declare unequivocally that the creation of the RTO structure would not deprive the transmission owners of their statutory rights under these sections of the Act. FERC's failure to clarify its rule to acknowledge that the transmission owners' statutory rights would not be infringed upon in the context of RTO-mandated expansions and interconnections was reversible error.

Under sections 210, 211, and 212, utilities cannot be required to expand their systems or provide physical interconnections <u>unless</u> the proposed activities are found by FERC to be in the public interest, the costs incurred by the transmission owners in connection with such activities are recoverable, and certain other determinations are made by FERC. 16 U.S.C. §§ 824i, 824j, 824k (1994). Since FERC cannot directly order transmission owners to expand their systems or provide interconnections without meeting these statutory requirements, the same result cannot be accomplished indirectly by vesting RTOs with the responsibility to direct such activities without a finding by FERC that any such expansion will comply with sections 210, 211, and 212. The courts consistently have held that FERC cannot achieve indirectly that which it cannot require directly. *National Fuel Gas Supply Corp. v. FERC*, 909 F.2d 1519, 1522 (D.C. Cir. 1990); *Richmond Power & Light v. FERC*, 574 F.2d 610, 620 (D.C. Cir. 1978). As a result, FERC must ensure that RTO-mandated expansions or interconnections meet all of the applicable statutory criteria.

FERC has recognized the importance of this issue, and it was error not to modify its rules accordingly. Section 210 (interconnections) and section 211 (wheeling) require FERC to find that the cost recovery requirements of section 212 have been met before an application can be approved. 16 U.S.C. §§ 824i(c)(3), 824j(a) (1994). The courts have recognized the statutory right of electric utilities to guaranteed cost recovery for mandated expansions and interconnections. Section 212(a) provides in this regard that any such order "shall ensure that, to the extent practicable, costs incurred in providing . . . of such services, are recovered from the applicant for such order and not from a transmitting utility's existing wholesale, retail, and transmission customers." 16 U.S.C. § 824k(a) (1994).[25] The express requirements of section 212 cannot be circumvented or modified under FERC's rulemaking authority.

Section 210 also sets forth the conditions under which FERC may issue an order requiring the physical interconnection of facilities. Along with providing notice and the opportunity for an evidentiary hearing, FERC is required to determine that any order directing the construction of an interconnection:

> (1) is in the public interest.
> (2) would –
>   (A) encourage overall conservation of energy or capital,
>   (B) optimize the efficiency of use of facilities and resources, or

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[25] In addition, FERC's failure to provide these assurances in the rulemaking decisions under appeal is contrary to the legislative intent in promulgating section 212. *See* H.R. 776, 102d Cong. (1992). The legislative history demonstrates that the intent of Section 212(a) was "to ensure that transmitting utilities and their customers do not subsidize the provision of transmission services for others and that transmitting utilities are fully compensated for use of their transmission system." 138 Cong. Rec. S. 17,613 (1992) (statements of Senator Johnston during Senate debate). In addition, the Senate record on this subject states that a "transmission customer must pay its own way and the third party transmission services will *not* be subsidized by native load customers under any circumstances." *Id.* at S. 17,619.

(C) improve the reliability of any electric utility system or Federal power marketing agency to which the order applies, and

(3) meets the requirements of section 212.

16 U.S.C. § 824i(c)(1)-(3) (1994).

Section 211 also imposes certain conditions on FERC's authority to issue an order mandating the expansion of transmission capacity. Among other things, section 211 requires FERC to:

(a) Issue an order "if it finds that such order meets the requirements of section 212, and would otherwise be in the public interest."

(b) Not issue an order under Section 211 or Section 210 "if, after giving consideration to consistently applied regional or national reliability standards, guidelines, or criteria, the Commission finds that such order would unreasonably impair the continued reliability of electric systems affected by the order."

(c) Not issue an order "which requires the transmitting utility subject to the order to transmit, during any period, an amount of electric energy which replaces any amount of electric energy – (A) required to be provided to such applicant pursuant to a contract during such period, or (B) currently provided to the applicant by the utility subject to the order pursuant to a rate schedule on file during such period with the Commission. . . ."

16 U.S.C. § 824j(a)-(c) (1994).

FERC cannot abdicate its responsibilities to make these determinations under sections 210, 211, and 212.[26] Nor can FERC lawfully delegate to RTOs its regulatory authority under the FPA to render such determinations, since RTOs are private, non-governmental entities. *See, e.g., Am. Trucking Ass'ns, Inc. v. United States*, 175 F.3d 1027 (D.C. Cir.), *reh'g granted in part and denied in part*, 195 F.3d 4 (D.C. Cir. 1999), *cert. granted,* 120 S.Ct. 2193 (2000); *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936); *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935). Such delegations of regulatory authority to private groups have been found to be unconstitutional.

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[26] With respect to section 211, the legislative history provides that the amendments to that section "does not give the FERC the authority, on its own motion, to order transmission and the enlargement of transmission facilities; FERC-ordered transmission is to occur only in direct response to the request of a third party, and only to the extent of that request." 138 Cong. Rec. S. 17,617. FERC is required to "consider all the relevant circumstances before determining whether to require transmission services." *Id.* The intent of the amendments to section 211 was for FERC to "consider the impact of the requested wheeling on the customers of the utility, the reliable functioning of the electric system in general, the customers now receiving transmission services, and the similar consequences to interconnected utilities and their customers." *Id.* In addition, the legislative history states that "[n]ew FPA section 211(b) denies the FERC authority to mandate wheeling if it fails to make a finding that a wheeling order would not 'unreasonably impair the continued reliability' of affected utilities."

If a utility disagrees with the need for (or rates, terms and conditions of) any RTO ordered expansions or interconnections, FERC must determine that any such RTO directive is consistent with the requirements of sections 210, 211, and 212 before any such determination would be effective. Any other result would amount to the circumvention of these statutory protections.

Furthermore, FERC's failure to unequivocally affirm the transmission owners' statutory rights under the new RTO structure cannot be reconciled with its express recognition "that a transmission owner is entitled to compensation for construction undertaken at the directive of an RTO. . . ." Order No. 2000-A, at 31,381 (JA 799). While FERC appears to recognize the existence of the transmission owners' rights to cost recovery under sections 210, 211, and 212, FERC's expectation that such "issues will be resolved systematically by the RTO" (*id.*) indicates that it is up to the RTO to ensure that such rights are protected, not FERC. This mere expectation that statutory rights will be protected is directly at odds with the explicit language of sections 210, 211, and 212 and the clear statutory intent. Indeed, FERC's orders are largely silent as to its role under the RTO structure on the issue of expansions and interconnections. Neither the true nature of FERC's decision nor its reasoning are discernable from the orders under review. As a result, FERC's determinations on the issue of RTO-mandated expansions and interconnections are not the product of reasoned decision making. See, e.g., *City of Vernon*, 845 F.2d at 1046; *Carolina Power & Light Co. v. FERC*, 716 F.2d 52, 55 (D.C. Cir. 1983); *Public Sys. v. FERC*, 606 F.2d at 982. FERC failed to provide a "rational connection between the facts found and the choice made." *Kansas Gas & Elec. Co. v. FERC*, 758 F.2d 713, 721 (D.C. Cir. 1985).

The Court should reverse and remand the Final Rule with instructions that FERC unequivocally state that the transmission system expansions and interconnections under RTO structures must be consistent with sections 210, 211, and 212. The RTO structure created by Order No. 2000 does not, and cannot, alter the statutory rights of transmission owners under the FPA. In the absence of an amendment to the FPA by Congress, these rights *must* be enforced. Consequently, FERC's actions here were arbitrary, capricious and not in accordance with law. *City of Dothan*, 684 F.2d at 164.

CONCLUSION

For the foregoing reasons, this Court should grant the petitions for review, vacate the portions of the Orders identified herein, and remand for further proceedings before the Commission.

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ADDENDUM

Sections of the Federal Power Act

Sections of the Natural Gas Act

Federal Regulations

Congressional Record